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No. 82-1041

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

ESTHER C. DICKMAN AND ESTATE OF PAUL B. DICKMAN, Deceased, G. WENDELL SMITH, Personal Representative,
Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

Brief Of Amicus Curiae Jones, Day, Reavis & Pogue In Support Of Petitioners

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QUESTION PRESENTED

Whether forbearance to demand repayment of an interest-free demand loan constitutes a gift for tax purposes.

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INTEREST OF AMICUS CURIAE

Jones, Day, Reavis & Pogue is a law firm with principal offices in Cleveland, Columbus, Dallas, Los Angeles, and Washington, D.C. A number of its clients are interested in the outcome of this case, because they are in a position substantially identical to that of the petitioners. The tax liability of these clients will be directly affected if the decision below is affirmed.

Consent to file this brief from counsel for both sides has been filed with the Clerk of this Court.

STATEMENT

In this case the Commissioner seeks to expand section 2501(a)(1) of the Internal Revenue Code to permit the finding of a "deemed" or "constructive" gift, subject to tax, when a person lends money to another on an interest-free demand basis. The purported gift is not of the principal of the loan, but of the forbearance, without interest, in demanding repayment. It is said that such forbearance fits within the general language of section 2501(a)(1), which imposes a gift tax on a "transfer of property by gift." No question is raised in this case as to the power of Congress to impose a tax in such a situation, by the enactment of specific language making its intention clear.

The Commissioner's arguments, summarized, are: that section 2501(a)(1) has been read broadly before, and should be so read here to encompass the Commissioner's "forbearance" theory; that fifty years of contrary history, administrative and judicial, is irrelevant; and that the Commissioner's "forbearance" theory, including the many technical problems it presents, is best worked out through the courts, with no further legislation required.

The Decisions Below

The Tax Court below held that no gift tax consequences resulted from an interest-free demand loan. *Dickman v. Commissioner*, 41 T.C.M. (CCH) 620 (1980). The Court of Appeals for the Eleventh Circuit reversed. 690 F.2d 812 (1982).

The Tax Court below relied on the decision of the district court in *Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966), and its own decision, reviewed by the full Tax Court and affirmed by the Court of Appeals for the Seventh Circuit, in *Crown v. Commissioner*, 67 T.C. 1060 (1977), *aff'd*, 585 F.2d 234 (1978). These were the only two cases which had previously considered the issue. The Tax Court held in *Crown* that

"[t]he Courts have uniformly rejected every attempt by the Internal Revenue Service to subject the making of non-interest bearing loans to income or gift tax consequences . . . [and] if the scope of the gift tax law is to be expanded to encompass such permissive use, we think it should come through congressional action, and not through unnecessarily broad judicial interpretation." 67 T.C. 1060, 1064-65. The court of appeals in *Crown* held similarly, explaining that the Commissioner's theory implied "a broader concept of what constitutes a property right under the gift tax laws than has heretofore been recognized." 585 F.2d 234, 240.

The court of appeals in *Dickman*, relying on the "clear, sweeping intent" of the gift tax laws, and on cases involving cash or other property loaned not on demand but for a term, disagreed with *Johnson* and *Crown* and held that forbearance to demand repayment on an interest-free demand loan constituted a transfer of property by gift. The court of appeals remanded, however, to calculate the value of this purported "property transfer."

SUMMARY OF ARGUMENT

1. It is uncontroverted that the terms "gift" and "property" have been given a broad reading for gift tax purposes. This is comparable to the broad reading given the term "income" for income tax purposes. Despite these broad readings, the Commissioner made no argument that an interest-free demand loan could result in the receipt of income or a gift for several decades after the passage of the income and gift tax laws, respectively. Nor, despite these broad readings, had any court so held until the decision below.

This issue has been extensively litigated in the income tax area.[1] In each instance, the Commissioner has been told that his theory, although arguably encompassed by the broad reading given to "income," should be pursued in Congress. The

[1] The leading case is *Dean v. Commissioner*, 35 T.C. 1083 (1961). Nine other cases upholding *Dean* are discussed below.

Commissioner was similarly instructed in *Johnson* and *Crown*. These decisions are grounded as much in the belief of the courts involved that they *should not* interpret the tax laws as expansively as required to encompass the Commissioner's theory, as they are in the belief that the tax laws *cannot* fairly be so read. The decision below should not be affirmed, therefore, not only because this would require resolution of the very difficult issue as to whether the tax laws *can* fairly be so read, but because it would contradict the almost universal advice of the courts that they *should not* be. In application of the principle that taxes should be imposed by Congress, and not by expansive judicial interpretation, this Court should uphold the Tax Court and the reasonable expectations of taxpayers, and require the Commissioner to seek the authorization of Congress before pursuing his theory.

2. Without specific congressional authority, the efforts of the Commissioner to impose tax consequences in other circumstances involving the absence of a stated interest charge—for example, in installment sales or dealings between related corporations—have been consistently rejected. This has followed from the realization of the courts that Congress has been both specific and articulate when it intended interest to be taken into account for tax purposes. To this end, the Internal Revenue Code contains numerous provisions setting forth the particular circumstances requiring interest and the exact rates to be used. Moreover, where the Commissioner has gone to Congress and explained a potential abuse arising from the failure to provide for interest in a particular circumstance, congressional action has often followed—and the courts have thereafter had clear rules with which to work. But in the absence of such authority, the courts have not deemed it prudent to require payment or imputation of an additional sum, where none was required by the parties, to reflect the "value" of some nebulous "property right" on the order of "the forbearance to demand repayment." The decision below should be reversed in accordance with this practice, and the specific rules necessary to implement the Commissioner's theory should be sought in Congress.

3. The Commissioner has failed to develop his theory fully, leaving numerous technical tax problems to be resolved by the courts. For example, the Commissioner's theory holds that the interest-free portion of an interest-free demand loan constitutes a gift, the value of which is determined by some measure of imputed interest during the period in which no demand for repayment is made. But the Commissioner has shown little inclination to remove from the income tax obligations of the borrower any interest actually received, though this interest clearly should not be taxed to the borrower if it is, as the Commissioner contends, a gift. Section 102(a) of the Internal Revenue Code specifically provides that "[g]ross income does not include the value of property acquired by gift . . ." Although this issue could be addressed by a highly articulated statute of the sort enacted by Congress in the grantor trust area,[2] the Commissioner is currently without such authority. As a result, the Commissioner must contend that the opportunity to receive interest, measured after-the-fact, is property separate and distinct from the interest itself. In other words, according to the Commissioner, the borrower receives two things of value—(1) the opportunity to receive interest, which is subject to the gift tax, and (2) the interest itself, which is subject to the income tax. This is a strange alchemy, which leaves a person loaned $100 at a time when interest rates stand at 20% with $140 at the end of a year.

The Commissioner's ideas as to the interest rate to be used in valuing the "gift" are also half-formed. He has used not only a different rate, but a different standard, in each of *Johnson*, *Crown*, and the case below. The rate and standard argued for now—20% in 1982 and 16% compounded daily in 1983[3]—is well in excess of any rate a borrower could have received on demand funds. It also would have been usurious in many states had it actually been charged by the lender.

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[2] Section 671 *et seq.* of the Internal Revenue Code.

[3] These rates were derived from section 6621 of the Internal Revenue Code, which sets the rate of interest for over- and underpayments of tax. This rate is changed semi-annually.

The Commissioner also cannot explain why the gift and estate tax, unified since 1976, should be higher on, say, $100 loaned on an interest-free demand basis, than it would be on $100 kept in a checking account or $100 given away outright. The tax in the latter two situations would be imposed on $100, and there could be no argument of tax avoidance. The person with his money in the checking account is under no obligation to invest it speculatively so as to increase his estate, and outright gifts are, of course, permitted. But in the case of the loan, using the 20% rate cited by the Commissioner below, the tax would be imposed on $200 if demand for repayment were made after 5 years. Congress could perhaps require such a result, but that question need not be decided here. What is clear is that Congress has not yet specifically undertaken to impose such a tax.

ARGUMENT

I. No Court Has Previously Held That an Interest-Free Demand Loan Could Result in the Receipt of Income or a Gift.

Until the decision below, the Commissioner had never successfully asserted that an interest-free demand loan could result in the receipt by the borrower of income or a gift. In fact, for 47 years after the adoption in 1913 of the first income tax law, and for 42 years after the adoption in 1924 of the forerunner of section 2501(a)(1) and the rest of the gift tax laws, the Commissioner never asserted—let alone successfully—that an interest-free demand loan could produce such tax consequences. This administrative interpretation of the income and gift tax laws was adopted contemporaneously with these laws, by the persons "charged with the responsibility of setting [their] machinery in motion."[4] It was continued throughout the drafting of most of the major regulations implementing these laws.

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[4] *Norwegian Nitrogen Products Co. v. United States*, 288 U.S. 294, 315 (1933) (Justice Cardozo). It has been the consistent and salutary practice of this Court to give great weight to the contemporaneous interpretation adopted

(footnote continues)

In 1961, however, in the *Dean* case, 35 T.C. 1083 (1961), the Commissioner did assert that an interest-free loan produced *income* taxable to the borrower. This assertion was rejected by the Tax Court, which held flatly that "an interest-free loan results in no taxable gain to the borrower." 35 T.C. 1083, 1090.

No appeal was pursued in *Dean*, and 12 years passed before there was any public announcement indicating the Commissioner's disagreement. A so-called "non-acquiescence" was published in 1973,[5] however, and an effort was started to overturn *Dean*. In the last four years, this effort has brought at least nine cases to the Tax Court raising questions as to the income taxation of interest-free loans.[6] In these cases, the Commissioner has relied on the broad meaning given to the

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(footnote continued)

by the persons charged with the administration and enforcement of a statute, and to scrutinize closely any assertion that such an interpretation should be upset: "In the construction of a doubtful and ambiguous law, the contemporaneous construction of those who were called upon to act under the law, and were appointed to carry its provisions into effect, is entitled to very great respect." *Edward's Lessee v. Darby*, 25 U.S. (12 Wheaton) 206, 210 (1827). This has been true even where the interpretation arises out of inaction: ". . . just as established practice may shed light on the extent of power conveyed by the general statutory language, so the want of assertion of power by those who presumably would be alert to exercise it, is equally significant in determining whether such power was actually conferred." *Federal Trade Commission v. Bunte Bros.*, 312 U.S. 349, 352 (1941) (Federal Trade Commission first asserted power to regulate certain intrastate transactions 25 years after passage of Trade Commission Act). "Failure to use such an important power for so long a time indicates that the Commission did not believe the power existed." *Federal Power Commission v. Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 513 (1949) (Federal Power Commission had never before asserted right to regulate gas leases).

[5] 1973-2 C.B. 4.

[6] *Baker v. Commissioner*, 75 T.C. 166 (1980); *Parks v. Commissioner*, 40 T.C.M. (CCH) 1228 (1980); *Beaton v. Commissioner*, 40 T.C.M. (CCH) 1324 (1980); *Marsh v. Commissioner*, 73 T.C. 317 (1979); *Greenspun v. Commissioner*, 72 T.C. 931 (1979); *Zager v. Commissioner*, 72 T.C. 1009 (1979); *Creel v. Commissioner*, 72 T.C. 1173 (1979); *Martin v. Commissioner*, 39 T.C.M. (CCH) 531 (1979); and *Suttle v. Commissioner*, 37 T.C.M.

(footnote continues)

term "income" for tax purposes, and the general proposition that Congress intended to exercise its taxing powers fully in the income tax area.[7] Despite this argument, the Commissioner has been uniformly unsuccessful. Although noting that the issue is not free from doubt, the Tax Court has taken notice of the longstanding administrative interpretation preceding *Dean* and the absence of legislation since *Dean*, and has consistently followed *Dean*.

More important, appeals of these cases have been decided against the Commissioner by the First, Second, Fourth, Fifth, Sixth, and Ninth Circuits, again despite the broad meaning given to the term "income" for tax purposes.[8] (The decision of the Sixth Circuit came after that of the court below.) No circuit has decided in favor of the Commissioner. In reaching their decisions, the courts of appeals have taken notice of the Commissioner's change in administrative practice, the passage of twelve years before the public announcement disagreeing with *Dean*, and the reasonable expectation of taxpayers relying on *Dean* and prior administrative practice.

The Commissioner dismissed the *Dean* line of cases, both below and in *Crown*, because they were not gift tax cases. This dismissal is too facile, however, because the crux of both the Commissioner's case and the decision below is the broad

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(footnote continued)

(CCH) 1638 (1978). A Court of Claims trial judge has recently accepted the Commissioner's theory in *Hardee v. United States*, 82-2 U.S.T.C. (CCH) ¶ 9459 (Ct. Cl. 1982).

[7] *See, e.g., Commissioner v. Lobue*, 351 U.S. 243, 246 (1956); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955) (Congress intended in income tax area to exert "the full measure of its taxing power"); *Commissioner v. Smith*, 324 U.S. 177, 181 (1945) (income is "any economic or financial benefit . . . whatever the form or model by which it is effected").

[8] *Parks v. Commissioner*, 686 F.2d 408 (6th Cir. 1982); *Baker v. Commissioner*, 677 F.2d 11 (2d Cir. 1982); *Commissioner v. Greenspun*, 670 F.2d 123 (9th Cir. 1982); *Beaton v. Commissioner*, 664 F.2d 315 (1st Cir. 1981); *Martin v. Commissioner*, 649 F.2d 1133 (5th Cir. 1981) (affirming *Zager* and *Creel* as well); *Suttle v. Commissioner*, 625 F.2d 1127 (4th Cir. 1980).

meaning given to the terms "gift" and "property" for tax purposes, and the full power Congress intended to exercise in adopting the gift tax laws. This is precisely the argument made —and rejected—as to "income" in the *Dean* line of cases. In fact, it was the Commissioner who argued below that the income and gift taxes were comparable in this regard, citing in support many of the same cases, such as *Glenshaw Glass,* cited by him in the *Dean* cases. In effect then, six courts of appeals have held that, in the absence of legislation, the broad and uncontroverted meaning given to a principal operative tax term is not enough to impose tax consequences in an interest-free loan situation, given a longstanding and contrary administrative interpretation, a beacon case, and the reasonable expectations of taxpayers. One court, the court below, has held the opposite.[9]

To these six courts of appeals can be added a seventh, the court of appeals in *Crown.*[10] Despite arguments by the Commissioner in *Crown* as to the broad meaning given the terms "gift"

[9] It also is expected that the Commissioner will contend that the *Dean* line of cases are unpersuasive because they are based on the so-called "wash" that occurs when a borrower is deemed to realize interest income, but also gets a comparable interest deduction. (There is no such offsetting deduction in the gift tax area.) Both the concurring and dissenting opinions in *Dean,* however, showed that a "wash" would not necessarily occur. As a result, the majority was fully aware that, while it could note the possibility of a "wash," it could not ground its decision on this theory. Criticism of the "wash" theory and its role in *Dean* followed the Tax Court's decision, and the Commissioner used this in the cases succeeding *Dean.* Although the Tax Court acknowledged this criticism and the weakness of the "wash" theory in these cases, it made it clear that efforts to dismiss or distinguish *Dean* and its progeny based on the "wash" theory were not well-founded: ". . . our finding of no taxable income to the taxpayer [in *Dean*] was not grounded on the imputed interest deduction, but rather was based on the conclusion that 'an interest-free loan results in no taxable gain to the borrower.' " *Greenspun v. Commissioner,* 72 T.C. 931, 936.

[10] *See also Wells Fargo Bank, N.A. v. Cory,* 110 Cal. App. 3d 242, 167 Cal. Rptr. 778 (1980), in which the California Court of Appeals held that an interest-free demand loan did not constitute a gift for purposes of that state's gift tax.

and "property" for tax purposes, the court of appeals held that an interest-free demand loan did not result in the receipt of a gift. The court gave great weight to the Commissioner's longstanding and contrary administrative interpretation, the abrupt change in this practice represented by the Commissioner's position in the *Johnson* case, the Commissioner's long delay in announcing his disagreement with *Johnson*,[11] and the retroactive and adverse effect on the reasonable expectations of taxpayers inevitable from a contrary decision. The court also noted that the Commissioner had offered three theories as to why a "transfer of property by gift" could be found to result from an interest-free demand loan, but that two of these—the ones most consistent with the gift tax laws—could not be accurately applied to a demand loan. The court found that the third theory—that the gift is made by serial forebearance—could be accurately applied to a demand loan, but that this theory stretched the gift tax laws to the breaking point. The court below relied on this third theory.

Affirming the decision below, therefore, will mean that this Court believes the tax laws can and should be so "stretched." Such a decision would be contrary to this Court's longstanding practice of giving great weight to the contemporaneous interpretation adopted by the persons charged with a statute's enforcement and contrary as well to the decisions of the Tax Court (the basic court for deciding tax cases, *cf. Dobson v. Commissioner*, 320 U.S. 489 (1943)), a district court, and seven courts of appeal.

II. The Result Desired by the Commissioner Requires Further Legislative Action.

Affirming the decision below will also mean that this Court believes the tax laws should be given an expansive interpretation in an ambiguous situation, *without further action by Congress*. This, too, would be contrary to the decisions of all but

[11] This disagreement was finally announced in Revenue Ruling 73-61, 1973-1 C.B. 408.

the court below. In *Dean* and the subsequent income tax cases, for example, the Tax Court repeatedly urged the Commissioner to seek recourse in Congress, stating that the interest-free loan situation was "peculiarly one that call[ed] for a legislative remedy." *Baker v. Commissioner*, 75 T.C. 166, 170. The decisions affirming these cases also held that any change in this area should be made by Congress, and they were particularly critical of the type of administrative lawmaking advocated by the Commissioner: "Where, as here, the Government seeks to modify a principle of taxation so firmly entrenched in our jurisprudence, it should turn to Congress, not the courts." *Commissioner v. Greenspun*, 670 F.2d 123, 126.[12]

In the gift tax area, both the district court in *Johnson* and the Tax Court in *Crown* and *Dickman* made it clear that more specific congressional authorization was required before the Commissioner could pursue his theory. In affirming *Crown*, the Court of Appeals for the Seventh Circuit also stated that it was "undesirable" to adopt the Commissioner's theory "by judicial construction." 585 F.2d 234, 241.

This Court recently decided a case very similar to this one, in which it held that lunch reimbursement money did not fall within the broad meaning given to the term "wages" for

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[12] Several of these decisions also quoted this Court's discussion of the respective roles of Congress and the judiciary in tax lawmaking:

> Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far-reaching consequences. When a principle of taxation requires reexamination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.

United States v. Byrum, 408 U.S. 125, 135 (1972). Following *Byrum*, Congress exercised its judgment and made the law clear by amending Section 2036(b) of the Internal Revenue Code — with, of course, prospective effect. *See also Helvering v. Griffiths*, 318 U.S. 371, 402-404 (1943), where this Court's decision that the tax law could not properly be construed as the Commissioner wished was followed by congressional action making the law specific.

withholding tax purposes. *Central Illinois Public Service Co. v. United States*, 435 U.S. 21 (1978). In reaching its decision, this Court noted that Congress could clarify such issues if it wanted, but in the meantime the Court could not "justify the Government's attempt to do so by judicial determination." 435 U.S. 21, 33. Justice Powell, in a concurring opinion, pointed out the dangers posed to the reasonable expectations of taxpayers when novel theories were adopted by the Commissioner without clear congressional authorization:

> It seems particularly inappropriate for the Commissioner, absent express statutory authority, to impose retroactively a tax with respect to years prior to the date on which taxpayers are clearly put on notice of the liability . . . In view of the complexities of federal taxation, fundamental fairness should prompt the Commissioner to refrain from the retroactive assessment of a tax in the absence of such notice or of clear congressional authorization.

435 U.S. 21, 38.

The theory of the Commissioner in this case is not only novel and without clear congressional authorization, but contrary to the prior administrative interpretation and the decisions of all but the court below. And it is clear that adoption of the Commissioner's theory will retroactively damage the reasonable expectations of taxpayers, while giving rise to many additional questions requiring "judicial determination." Accordingly, this Court should adopt the approach set forth in *Byrum* and *Central Illinois Public Service*, by requiring specific congressional authorization before permitting the tax urged by the Commissioner to be imposed.

III. Where Interest Is to Be Taken into Account under the Tax Laws, the Internal Revenue Code Is Specific; Moreover, the Courts Have Uniformly Rejected Efforts to Charge or Impute Interest in the Absence of Such Authority.

Congress knows how to tax interest, or to allow for it, when it wishes to do so. The Internal Revenue Code contains dozens of different sections and subsections describing the circumstances under which interest is required, and specifying the

rates to be applied.[13] These include sections where Congress has specifically required that loans carry a "reasonable" rate of interest,[14] and sections where loans will not be permitted or recognized unless no interest or interest at a rate "significantly less" than that prevailing is stated.[15] These also include highly complex sections "creating" interest, or a property right equivalent to interest.[16] These sections are supplemented by lengthy regulations detailing when interest must be charged and at what rates.[17] But there is no such specific section nor regulation supporting the theory pursued by the Commissioner in this case.[18]

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[13] Many of these provisions are listed in Appendix A to this brief. *See also* Note, *Determining Interest under the Internal Revenue Code*, 34 Stan. L.Rev. 639 (1982).

[14] *See, e.g.*, sections 503(b), 503(d)(2), 503(f), and 4975(d).

[15] *See, e.g.*, sections 514(c)(9)(B)(v)(II), 1481(b)(3), and 4941(d)(2)(B).

[16] For example, section 1232 requires taxpayers holding interest-free or low interest bonds to report a portion of the bonds' redemption price as "original issue discount," or interest, over the life of the bonds.

[17] *See, e.g.*, Treasury Regulations § 1.482-2, 26 C.F.R. § 1.482-2, which covers loans between related parties on which either "no interest" or interest "which is not equal to an arm's length rate" is charged. The regulation provides that the Commissioner can impute interest at an arm's length rate, and sets forth 11%, 12%, and 13% simple interest as "safe harbor" rates.

[18] The gift tax law was amended 17 times between its adoption in 1924 and the decision in *Johnson* — that is, during the period when those charged with its adminstration did not believe an interest-free demand loan constituted a gift. The gift tax law has been amended nine additional times since *Johnson*, and three times since *Crown*. *See* Appendix B to this brief. Only a technical corrections act has been adopted since the decision below. Congress must have known during this period that family members and friends often lent each other funds, without charging interest, to meet medical or other emergencies, pay college expenses, make a downpayment on a home, or for other non-business reasons. Congress also must have known that family members let each other "use" property free of charge — as, for example, when an elderly and ailing parent lives out his life with his children. Despite this knowledge, and despite the frequent action taken with respect to the gift tax law, Congress has never seen fit to require that interest be charged on a non-business loan to avoid gift tax consequences. Where a law has received a contemporaneous interpretation by those charged with its administration, where it has been similarly interpreted by the courts, and where it has been

(footnote continues)

Where the Commissioner has tried to impose tax consequences because of the interest-free nature of a transaction without such specific authority, moreover, he has been consistently turned back by the courts.[19] This was perhaps best

(footnote continued)

subsequently amended and otherwise acted upon without changing the interpretation of the administrators or courts, the "reenactment" rule is properly applied. *See, e.g.*, Sutherland on Statutory Construction, § 49.09 (4th Ed. 1973); *Lorillard v. Pons*, 434 U.S. 575 (1978); *Shapiro v. United States*, 355 U.S. 1 (1948).

[19] *See, e.g., Tennessee-Arkansas Gravel Co. v. Commissioner*, 112 F.2d 508 (6th Cir. 1940) and *Smith-Bridgman & Co. v. Commissioner*, 16 T.C. 287 (1951), acq. 1951-1 C.B. 3, and compare them to *B. Forman Co. v. Commissioner*, 453 F.2d 1144 (2d Cir.), *cert. denied*, 407 U.S. 934 (1972) (decided after Congress granted the Commissioner authority to issue regulations imputing interest on interest-free or low-interest transactions between related parties under section 482 of the Internal Revenue Code). *See also Lupowitz Sons, Inc. v. Commissioner*, 497 F.2d 862 (3d Cir. 1974); *Saunders v. United States*, 294 F.Supp. 1276 (D. Hawaii 1968), *rev'd* on another issue, 450 F.2d 1047 (9th Cir. 1971); *Brandtjen & Kluge, Inc. v. Commissioner*, 34 T.C. 416 (1960); *Society Brand Clothes, Inc. v. Commissioner*, 18 T.C. 304 (1952); and *Combs Lumber Co. v. Commissioner*, 41 B.T.A. 339 (1940).

Nor are *Berkman v. Commissioner*, 38 T.C.M. (CCH) 183 (1979) or *Blackburn v. Commissioner*, 20 T.C. 204 (1953), the cases relied on by the court below, to the contrary. *Berkman* and *Blackburn* involved low-interest *term* loans, not loans payable on demand. Although the court below deemed these two types of loans equivalent, this is obviously incorrect. Even the commentators who are critical of *Crown* acknowledge that a demand loan, enforceable at once and at will, is more like a revocable trust and is clearly different from a term loan. *See, e.g.*, Joyce & Del Cotto, *Interest Free Loans: The Odyssey of a Misnomer*, 35 Tax L. Rev. 459, 460 (1981) (in contrast to a term loan, a demand loan "is a completely revocable transaction, and, since the borrower never receives the right to use the money for any particular time, it could be properly viewed as no loan at all"). The Commissioner also admitted below that demand and term loans are different, both as to timing and value. Perhaps the most important difference is that a demand loan is worth face value at any given moment. A term loan, in contrast, may be worth less or more than face, based on its interest rate or the length of its term. This means that the note given in a term loan situation might be worth less than the cash or property received in exchange. But the Commissioner has long had specific statutory authority with respect to such unequal exchanges. *See, e.g.*, section 2512(b) of the Internal Revenue Code. (The Commissioner's attempt to apply this particular section to a demand loan was rejected in *Crown*, and was not adopted by the court in reaching its decision below.)

seen in the installment sale area, where the Commissioner was unsuccessful in arguing that a person selling goods over time on an interest-free basis could be charged with the receipt of interest. *See, e.g., Brown v. Commissioner,* 37 T.C. 461 (1961), *aff'd,* 325 F.2d 313 (9th Cir. 1963), *aff'd,* 380 U.S. 563 (1965); *Pretzer v. United States,* 61-1 U.S.T.C. (CCH) ¶ 9477 (D. Ariz. 1961). The Commissioner took his concern to Congress, which thereafter added section 483 to the Internal Revenue Code.[20] This section authorizes the Commissioner to characterize as interest a portion of the sale price in an installment transaction, if interest below a specified rate is not required by the parties. But section 483 also provides a detailed set of rules guiding and limiting the Commissioner—as the decision below cannot. Section 483 provides, for example, that no interest may be imputed if the installment transaction is of less than a year's duration or involves less than $3,000. Section 483 also sets forth the exact interest rate to be used when interest may be imputed. The Commissioner has claimed that he can achieve similar results in the interest-free loan situation through administrative grace, but the wisdom and efficiency of this is open to question. (The Commissioner has already used three different interest rates and three different standards in the three cases litigated to date.)

In sum, affirming the decision below would be contrary to the very specific approach to interest adopted throughout the Internal Revenue Code, and would be contrary to the wide respect granted by the courts to this approach. Affirming the decision below will also foster much additional litigation, while the courts develop guidelines and limits which would be better provided by prospective statute and regulations.

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[20] The Commissioner has since issued over 50 pages of regulations detailing the application of section 483. Treasury Regulations § 1.483, 26 C.F.R. § 1.483.

IV. The Gift Tax Theory Offered by the Commissioner and Accepted Below Is Not Fully Developed, and Creates Both Inconsistencies in Tax Law and New Issues Requiring Litigation.

A. *If the loan is a gift, there should be no income to the borrower.* Under federal tax law, the recipient of a gift is not subject to income taxation on that gift.[21] Accordingly, if an interest-free demand loan is treated as a gift because the funds borrowed can be used to earn interest or other income without obligation to the lender, the borrower should not be subject to income taxation on the interest or other income so earned, since this is precisely the benefit alleged to be received by gift. Even those commentators who contend that interest-free loans constitute gifts admit that taxing the borrower on such interest or other income is a distortion of existing law. Some of these commentators believe the Commissioner can "expand" the law to reallocate this interest or other income to the lender, but most believe legislation is needed.[22]

Perhaps because such legislation has not been obtained, the Commissioner has not seen fit to relieve the borrower of income taxation with respect to such interest or other income. To rationalize this in the face of the clear rule to the contrary set forth in section 102(a) of the Internal Revenue Code, the Commissioner maintains that the opportunity to receive interest, obtained in an interest-free loan, is separate and distinct, with a separate value, from the interest or income, if any, actually earned. Taken to its logical conclusion, this means that a person (1) holding the right to receive interest, valued as it was by the Commissioner below using a rate of 20%, and (2) actually receiving interest at 20%, is wealthier by 40%—since he has received interest of 20%, and, on the Commissioner's theory, has also received a gift of 20%.

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[21] Section 102(a) of the Internal Revenue Code provides: "Gross income does not include the value of property acquired by gift . . ."

[22] Roth, *Can Lender Be Charged with Receiving Taxable Income as a Result of an Interest-Free Loan?*, 52 J. Tax. 136 (1980); Joyce & Del Cotto, *Interest-Free Loans: The Odyssey of a Misnomer*, 35 Tax L.Rev. 459 (1979-1980); Frazier, *Interest-Free Loans between Family Members: What Practitioners Can Expect after Crown*, 48 J.Tax. 28 (1978); Note, *Gift Taxation of Interest-Free Loans*, 19 Stan. L.Rev. 870 (1967).

One need not rely on this example, however, to show that the Commissioner is wrong in his contention that the opportunity to use money or property is separate and distinct from the interest or other income actually earned. Prior to the Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487, taxpayers could donate cash or property to a charity for a term and receive a "double benefit"—they could (1) exclude the income derived from the property during the term, and (2) take a charitable contribution deduction for the value of the term.[23] The Commissioner presented to Congress the argument that such taxpayers were getting a "double benefit," since they excluded income from the property during the term, and also received a

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[23] This practice was accepted in *Abbott v. United States*, 74-2 U.S.T.C. (CCH) ¶ 13040 (S.D. Miss. 1974) (right to use property for the life of another); *Thriftimart, Inc. v. Commissioner*, 59 T.C. 598 (1973) (leasehold terminable on sale of building); *Allen v. Commissioner*, 57 T.C. 12 (1971) (term leasehold); *Threlfall v. United States*, 302 F.Supp. 1114 (W.D. Wisc. 1969) (term leasehold); *Passailaigue v. United States*, 224 F.Supp. 682 (M.D. Ga. 1963) (use of property terminable on fifteen days notice, treated by the court as equivalent to *Sullivan, infra*); and *Sullivan v. Commissioner*, 16 T.C. 228 (1951) (right to use property for duration of war). These cases were central to the decision below, which cited them to prove that the use of property itself constituted property, which could then be subject to gift taxation. But reliance on these cases was misplaced. *First*, these cases involved charitable deductions, and the operative statute in each required only a "contribution," not a "transfer of property by gift." *Second*, the Commissioner and the Congress have agreed that the cases involved a "double counting" of the property involved. *Third*, and perhaps most important, the court below failed to distinguish between a contribution for a term, and one subject to demand. Noting that some of the cases involved contributions for *indefinite* terms (for example, property contributed for the duration of the war), the court below concluded that such arrangements were the equivalent of contributions subject to demand. But this conclusion is unwarranted, because the donor is not in control of the duration of the contribution when property is transferred for an indefinite term, but he is in continuous control when the arrangements are subject to demand. This distinction — whether or not the donor is in control — is important throughout federal tax law and regulations. Compare, for example, Treasury Regulations § 25.2512-5(c), 26 C.F.R. § 25.2512-5(c), which treats a transfer of the right to use property for the life of another as a gift, with Treasury Regulations § 25.2511-2(b), 26 C.F.R. § 25.2511-2(b), which shows that a transfer to a grantor or revocable trust is not.

deduction for the gift.[24] Congress agreed that "the right to use the property . . . represent[s] the equivalent of the rental income from the property," and passed legislation to eliminate the "double benefit."[25]

For the same reason, the Commissioner is "double counting" when he treats the borrower of an interest-free demand loan as the recipient of both a gift and of income on the funds borrowed. As in the case of the "charitable contribution of property for a term," the Commissioner should recognize that his tax theories need further development—and legislation— to correct this distortion.

B. *There is no clear basis on which a court can determine the amount of the "gift."* The Commissioner has no coherent theory as to the amount of the "gift," if any, in this situation, nor has he produced any evidence as to the "amount" which he claims should be treated as a "gift." He prefers instead to use "safe harbor" rates, although he has no statutory authority for this. Indeed, he has used three different rates and three different standards in *Johnson, Crown,* and the case below. In *Johnson,* he used 3½% and the method prescribed in Treasury Regulations § 25.2512-5 for valuing annuities, life interests, and remainder interests.[26] In *Crown* he used 6%, based on the prevailing prime rate. In the court below, he used rates up to 20%, as determined under section 6621.

It was clear in the case below, however, that 20% exceeded any return the borrower could have earned on demand funds, since saving accounts were paying approximately 4½% to 6%

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[24] *See* Griswold, *Charitable Gifts of Income and the Internal Revenue Code,* 65 Harv. L.Rev. 841 (1951).

[25] H. Rep. No. 91-413, 91st Cong., 1st Sess. 58 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 83-84 (1969); sections 170(f)(3)(A) and 2522(c) of the Internal Revenue Code. Section 170(f)(3)(A) eliminates the contribution deduction for income tax purposes, while section 2522(c)(2) eliminates the gift tax deduction. Section 2522(c)(2) poses another technical problem for the Commissioner's gift tax theory: An interest-free loan to a charity would constitute a gift, but there would be no offsetting gift tax deduction to prevent imposition of the gift tax.

[26] 26 C.F.R. § 25.2512-5.

and checking accounts, if interest-bearing, were paying slightly less. Moreover, the Commissioner admitted in *Crown* that the appropriate interest rate and method would vary according to the facts and circumstances, including those particular to the lender and borrower and those concerning general economic trends. The additional litigation this will foster is obvious.[27]

Nor is it correct to argue that imposition of the gift tax will eliminate interest-free demand loans, so that the additional litigation predicted is hypothetical. The gift tax theory accepted by the court below applies not only to interest-free loans, but to loans bearing interest at either too low or too high a rate. For example, a loan bearing a 5½% interest rate, equal to the rate on savings accounts, would constitute a gift if the Commissioner's 20% rate and method are correct. Conversely, a loan bearing a rate of, say, 23%, would constitute a gift by the borrower to the lender. In the absence of statutory guidelines, therefore, all loans not clearly in a business context—that is, all loans between family members, friends, and so on—would be subject to gift taxation.[28] This will make it impossible for such persons to make normal arrangements for emergencies in their families, or otherwise to plan their affairs.

C. *The Commissioner's theory taxes the same value twice.* Finally, the Commissioner's gift tax theory produces an additional, significant distortion: the gift tax on an amount lent to another can be greater than either the gift tax on the same

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[27] As previously noted, the court below remanded to the Tax Court for further proceedings concerning the appropriate interest rate and method.

[28] The problems inherent in determing whether an interest-free demand loan constitutes a gift, and in what amount, are apparent when one does consider the familial and friendly context in which such loans are usually made. Suppose, for example, that a father makes an interest-free loan to an adult daughter for the purpose of helping her in buying a house. The funds come from the father's checking account, where they would not otherwise be used. Or, suppose that a son makes an interest-free loan to his parents to help them meet emergency medical bills. Or suppose that an adult son in college is arrested, and the father makes an interest-free loan to him in order that he may arrange bail. How is the existence and value of the "gift" to be determined in such cases? Would it make any difference if the loan were made at a substantial rate of interest, say 10%, but less than the 20% rate which the Commissioner advances in this case?

amount *given outright*, or the unified gift and estate tax on the same amount *retained*. This results from the fact that the "value" of property reflects, in part, the capacity of property to produce income. Thus, taxing the property and also the income it has the capacity to produce taxes the same "value" twice. As a result, affirming the decision below will cause those who have made interest-free demand loans—in reliance on the Commissioner's administrative practice, *Johnson* and *Crown*, or the absence of specific statutory authority—to be charged with a large and retroactive expansion of their gift and estate tax obligations. This will be so even though these persons will not have and never have had the funds "represented" by this expansion, and would not be required to generate such funds had they never made the interest-free loans. In other words, these persons could have made an outright gift of, say, $100, and paid tax on that $100. They would not have been taxed on any amount they could have earned on the $100, or that the donee did earn on that $100. Or they could have kept the $100 —in a checking account, a safety deposit box, an investment that "breaks even," or the proverbial mattress—and paid tax on only the $100. Again, they would not have been taxed on any amount they could have earned on the $100.[29] But if the $100 is lent on an interest-free demand basis to a family member, the tax may be imposed on $120, $140, or more, depending on the time the loan is outstanding.[30] Such a system does not make sense on its face, and should not be sanctioned by this Court in the absence of additional congressional authorization.

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[29] Although substantial funds are kept in checking accounts, safety deposit boxes, and the like, one does not need to hypothesize funds held in a non-income producing manner to illustrate the distortions caused by the Commissioner's theory. Many persons keep funds in secure, but low-interest paying, government obligations. If a person held $100, for example, in a 6% U.S. Savings Bond and died one year later, the unified gift and estate tax would be imposed on $106. If this same person lent this $100 to a family member on an interest-free demand basis and died one year later, the unified gift and estate tax would be imposed, according to the Commissioner, on $120.

[30] In this case the principal of the amount of the loan was included in the lender's taxable estate, and tax was paid on it.

In sum, the Commissioner's still-developing gift tax theory (1) contravenes existing law by subjecting gifts to income taxation, (2) "double counts" as to interest earned, (3) offers little guidance regarding appropriate interest rates to persons lending money to family or friends, and (4) results in retroactive and distortedly high gift and estate taxes on interest-free loans. If recourse to Congress is not required, correcting and limiting these anomalies will require many additional court decisions.

CONCLUSION

In concurring in the opinion below, Judge Fay stated, "Taxpayers have given away no property, no interests, and no rights, but surely they have made a gift." 690 F.2d 812, 820. This remark captures perfectly the belief of the court below, shared by many commentators, that "something" of value is being transferred when a lender forbears to demand repayment of an interest-free demand loan. But it captures equally well the difficulty of conforming this "something" with the gift tax laws, which require "a transfer of property by gift" before a tax may be imposed. Here the only "transfer" of "property" was of the money loaned, but that transfer and that property are not what the Commissioner seeks to tax—and rightly so, for that transfer was not a "transfer of property by gift," as the statute requires, but was a "transfer of property by loan."

Moreover, the Commissioner made no claim for almost fifty years following passage of the income and gift tax laws that the "something" to which Judge Fay alludes produced either income or gift tax consequences. The Tax Court, a district court, and seven courts of appeals have agreed that no such consequences can attach, in the absence of additional and specific legislation shaping and limiting this "something." Congress has frequently enacted such legislation in other situations, describing, for example, the circumstances under which interest must be charged or imputed and the exact rates to be used. This practice is much preferable to retroactive taxation imposed by judicial decision, particularly when based, in whole or part, on the elusive notion that "something" is being transferred.

Accordingly, the decision below should be reversed, and the Commissioner should be barred from imposing gift tax liability until legislation is obtained making clear the intent of Congress, and resolving the many questions which are implicit in the Commissioner's wholly theoretical claim to a tax.

Respectfully submitted,

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APPENDIX A

INTERNAL REVENUE CODE SECTIONS WHERE CONGRESS HAS LEGISLATED WITH RESPECT TO INTEREST AND INTEREST RATES

Internal Revenue Code Section	Interest Rate Specified	Subject
101(d)(2)(B)(ii)	Rate used by the insurer in calculating policy payments	Certain insurance calculations
101(f)(2)(B)	Greater of 6% annual effective rate or minimum rate in insurance policy	Certain insurance calculations
101(f)(2)(C)	Greater of 4% annual effective rate or minimum rate in policy	Certain insurance calculations
103A(i)(2)	Not greater than 1.25% in excess of bond yield	Mortgage subsidy bond
103A(1)(8)	Actuarial basis, taking into account present value of money	Mortgage subsidy bond
163(b)	6% of average unpaid balance	Failure to state interest in installment purchase
167(q)	Average adjusted prime for a preceding six month period	Failure to retire certain boilers
168(i)(5)	Not greater than average adjusted prime for a preceding six month period	Limitation on interest paid in safe harbor lease
263(g)	Calculated by complex formula	Interest in the case of straddles
404A(g)(3)	20% above or below average rate on long-term corporate bonds	Permissible range of interest in foreign deferred compensation plans
411(a)(7)(C)	5% compounded annually	Interest on accrued benefit in pension and other plans

Internal Revenue Code Section	Interest Rate Specified	Subject
411(c)(2)(C)	5% compounded annually	Interest on accumulated contributions of interest on accrued benefit in pension and other plans
412(b)(5)	Appropriate rate consistent with plan rate	Minimum funding standards for pension and other plans
412(c)	Based on reasonable actuarial assumptions	Minimum funding standards
415(b)(2)(E)(i)	Not less than the greater of 5% or plan rate	Limitations on qualified plans
415(b)(2)(E)(ii)	Not greater than the lesser of 5% or plan rate	Limitations on qualified plans
483(b)	By regulation, currently 10% (unless 9% stated)	Unstated interest on deferred payments
483(g)	Not greater than 7% compounded semi-annually	Unstated interest on certain land transfers between related parties
503(b)	Reasonable rate	Loans by exempt organizations
503(d)(2)	Reasonable rate if payable on demand	Loans by certain qualified trusts
503(f)	Reasonable rate	Loans by certain qualified trusts to employees
514(c)(9)(B)(v)	Significantly less than rate otherwise available	Certain loans to exempt organizations
668	6% times complex formula	Interest charged on accumulation distributions from foreign trusts

Internal Revenue Code Section	Interest Rate Specified	Subject
801(b) and (g)	Assumed rates	Certain life insurance calculations
805(c)	Average rate assumed in calculating reserves	Calculation of life insurance reserve adjustments
805(f)	Calculated by complex formula	Calculation of guaranteed qualified interest
809(a)	Calculated by complex formula	Life insurance investment yield
1232	Generally difference between issue price and redemption price	Original issue discount on bonds and other indebtedness
1232A	Generally difference between issue price and redemption price, at "constant rate of interest"	Original issue discount on new issues
1232B	Generally difference between issue price and redemption price, at "constant rate of interest"	Original issue discount on stripped bonds
1397(b)	Average adjusted prime rate for a preceding six-month period	Rules applicable to an electing GSOC
1481(b)(3)	No interest may be charged	Renegotiation of government contracts
2032A(e)	Average annual effective rate for all new Federal Land Bank loans	Valuing farm
3451(b)	Assume whole payment is interest under certain circumstances, by regulation	Withholding on periodic payments
3452(d)	Not in excess of $150	Calculation of exemption for "minimal interest"

Internal Revenue Code Section	Interest Rate Specified	Subject
3554	Amount actually paid	Definition of interest whether or not designated as such
4941(d)(2)(B)	No interest may be charged	Certain loans to private foundations
4975(d)	Reasonable rate	Exemption from excise tax for certain loans
6049(b)	Amount actually paid	Definition of interest whether or not designated as such
6166(f)	Average adjusted prime rate for a preceding six-month period	Tax payment extension in case of closely-held business
6167(e)	Average adjusted prime rate for a preceding six-month period, payable annually	Tax extension in case of foreign expropriation loss
6332(b)	Contractual rate	Tax levies
6332(c)	Average adjusted prime rate for a preceding six-month period	Tax levies
6335(e)(3)	6% per annum	Deferral of payment in sale of seized property
6337(b)(2)	20% per annum	Redemption of property after levy
6601	Average adjusted prime rate for a preceding six-month period	Interest on underpayments
6602	Average adjusted prime rate for a preceding six-month period	Interest on erroneous refunds
6611	Average adjusted prime rate for a preceding six-month period	Interest on overpayments

Internal Revenue Code Section	Interest Rate Specified	Subject
6621	Average adjusted prime rate for a preceding six-month period	Interest determination for various tax purposes
6622	Average adjusted prime rate for a preceding six-month period	Compounding rule
7426(g)	Average adjusted prime rate for a preceding six-month period	Civil actions against wrongful levy
7506(d)	1% per month	Real estate administered by U.S.
9501(c)	Current average market yield on U.S. obligations	Black lung repayable advances

APPENDIX B
ACTS AMENDING GIFT TAX LAW*

Technical Corrections Act of 1982, P.L. 97-448, 96 Stat. 2365.

Economic Recovery Act of 1981, P.L. 97-34, 95 Stat. 172.

Revenue Act of 1978, P.L. 95-600, 92 Stat. 2763.

Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1520.

Internal Revenue Code Amendments of 1974, P.L. 93-625, 88 Stat. 2108.

Excise, Estate, and Gift Tax Adjustment Act of 1970, P.L. 91-614, 84 Stat. 1836.

Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487.

Foreign Investors Tax Act of 1966, P.L. 89-809, 80 Stat. 1539.

Tax Treatment of Certain Payments, 1966, P.L. 89-365, 80 Stat. 32.

Self-Employed Individuals Tax Retirement Act of 1962, P.L. 87-792, 76 Stat. 809.

Internal Revenue Amendments, 1960, P.L. 86-779, 74 Stat. 998.

Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606.

Internal Revenue Code of 1954, ch. 736, 68A Stat. 1.

Revenue Act of 1951, ch. 521, 65 Stat. 452.

Powers of Appointment Act of 1951, ch. 165, 65 Stat. 91.

Revenue Act of 1950, ch. 994, 64 Stat. 906.

Technical Changes Act of 1949, ch. 720, 63 Stat. 891.

Revenue Act of 1948, ch. 168, 62 Stat. 210.

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* *See also* Montgomery, Wynn & Blattmachr, Federal Taxes—Estates, Trusts, and Gifts, ch. 19 (1952).

Revenue Act of 1942, ch. 619, 56 Stat. 798.

Revenue Act of 1941 ch. 412, 55 Stat. 687.

Revenue Act of 1940, ch. 419, 54 Stat. 516.

Internal Revenue Code of 1939, ch. 2, 53 Stat. 1.

Revenue Act of 1938, ch. 289, 52 Stat. 447.

Revenue Act of 1935, ch. 829, 49 Stat. 1014.

Revenue Act of 1932, ch. 209, 47 Stat. 169.

Revenue Act of 1926, ch. 27, 44 Stat. 9.

Revenue Act of 1924, ch. 234, 43 Stat. 253.